Best practices for plan sponsors

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Should you include ESG funds in your retirement plan?

Maybe, maybe not.

ESG = Environmental, Social and Governance
SRI = Socially Responsible Investing

ESG, or environmental, social and governance funds, can be appealing to many investors, including millennials. These funds may be viewed as a proactive way to encourage reluctant and under-prepared millennials to save for retirement. But is it a good idea to include ESG funds in your plan's investment menu to entice investment do-gooders to boost their retirement savings? The short answer is, "it depends."

What are ESG funds?

Ethics-driven investment vehicles have existed since the 1970s. Initially, they sought to weed out companies that conflicted with investors' values, including tobacco, liquor and gambling stocks.

ESG investing has come a long way since then. Today, it is used to describe "socially conscious" investments — think companies purposefully using water more efficiently in their plants, firms with eco-friendly missions, or businesses setting up shop in underserved locations. And don't forget corporate governance, an often overlooked feature of ESG funds that includes practices like ethical behavior, fair executive pay and forthright financial reporting.

Evaluating ESG funds for your plan

Now that you know a bit about how ESG funds work, you may be wondering how to evaluate them effectively in the context of your investment selection process. Your plan's financial advisor can likely offer insights on specific funds and performance data. In addition, there are third parties who rate the underlying companies in ESG funds based on their sustainability or ESG practices. Even investment information and data provider, Morningstar, offers a dedicated ESG data and research platform which rates 20,000 funds worldwide.[1]

How about investment performance? There is a widespread perception that ESG factors may negatively impact performance.[2] However, some industry observers argue that incorporating ESG factors results in enhanced risk-adjusted returns, because companies with sustainable practices tend to be stronger, better prepared for the future, and more appealing to consumers.[3]

ESG funds: Yay or nay?

Thus far, the Department of Labor (DOL) has not looked favorably on the use of ESG funds in retirement plans. Although they have not ruled against using ESG options, the DOL has cautioned plan fiduciaries not to put too much emphasis on the funds' socially responsible mission as part of the investment selection and decision-making process.[4]

Due in part to the DOL's cautionary guidance, the uptake of ESG funds in retirement plans has been minimal — just 2% offered them as an option as of 2016.[5] That said, if you are considering adding ESG options to your plan, make sure to do the following as part of your fiduciary responsibilities:

- amend your investment policy statement (IPS) to reflect any updates to the plan's investing criteria
- make sure any ESG funds you select going forward adhere to the policies set forth in the IPS (i.e., regarding fees, diversification, management, and track record)
- provide additional participant communication and education, as many investors find these funds confusing
- be sure to include ESG funds in your plan's regular investment reviews

ESG funds may benefit the world given that they seek to invest in companies with socially-conscious missions. However, whether they are beneficial for your plan and participants is, ultimately, up to your plan's fiduciaries to decide. Choose wisely.

[1] Morningstar. "Sustainable Investing: Surfacing ESG Data and Research." 2018.
[2] Barney, Lee. PlanSponsor magazine. "GAO Explores Why Few Retirement Plans Embrace ESG Investing." August 2018.
[3] Hartnett, Judy Faust and Moore, Rebecca. Plan Adviser magazine. "What Would Encourage More ERISA Plans to Use ESG Investments?" November 2018.
[4] DOL. ESG Investment Considerations. April 2018.
[5] Barney, Lee. PlanSponsor magazine. "GAO Explores Why Few Retirement Plans Embrace ESG Investing." August 2018.